

7L-N-2823-70
Internal Revenue Service
memorandum

CC:TL:TS
JROSENBERG

date: APR 23 1990

to: District Counsel, Manhattan
Attn: Jeanette D. Schmelzle

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED] - Conversion of Partnership Items,
Statute of Limitations
TL-N-2823-90
CC:TL:TS Rosenberg, Wilson
I.R.C. §§ 6231, 6229
Conversion of Partnership Items, Statute of Limitations

This memorandum is in response to your request for tax litigation advice dated January 19, 1990.

Issues

1. Whether partnership items will convert to nonpartnership items with respect to subsidiary corporations when the subsidiary corporations are part of a consolidated return group and the parent corporation has been notified pursuant to Temp. Treas. Reg. § 301.6231(c)-5T that it is under criminal investigation.
2. If the partnership items do convert to nonpartnership items with respect to the subsidiary corporations, and there is fraud at the partnership level, can the statute of limitations on assessment be kept open with respect to the subsidiary corporations under section 6501(c).

Conclusions

1. If any member of a consolidated return group is a partner in a TEFRA partnership under section 6231(a)(2)(A), all other members of the group will be considered to be "partners" pursuant to section 6231(a)(2)(B) since every member of the group will have its tax liability determined in part by taking into account the partnership items of the subsidiary partner. Furthermore, since the tax liability of each member of the consolidated return group is determined based on the same partnership items reported

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on the consolidated return, if the partnership items convert to nonpartnership items with respect to one of the members of the group under section 6231(b), then the partnership items will have converted with respect to all of the other members of the group as well.

2- Section 6229(f) provides that the period for assessing any tax imposed by subtitle A attributable to converted items under section 6231(b) shall not expire before the date which is one year after the date on which the items become nonpartnership items. Therefore, if notice of conversion of partnership items is given to the [REDACTED] consolidated return group, then even if it is determined that there is fraud in connection with either the [REDACTED] or [REDACTED] partnership returns, the Service is still limited to the one year period of limitations provided by section 6229(f).

Facts

Situation One

[REDACTED] is a TEFRA partnership consisting of only [REDACTED] partners, [REDACTED] ([REDACTED] ownership interest) and [REDACTED] ([REDACTED] ownership interest). Both [REDACTED] and [REDACTED] have been part of the [REDACTED] consolidated return group for the [REDACTED] through [REDACTED] tax years. [REDACTED] is currently under criminal investigation.

Situation Two

[REDACTED] is a TEFRA partnership. Two of its partners are [REDACTED] and [REDACTED], as in situation one, [REDACTED] is part of the [REDACTED] consolidated return group. [REDACTED] is a partnership having as one of its partners [REDACTED]. [REDACTED] is owned by [REDACTED], which in turn is owned by [REDACTED]. However, [REDACTED] is not part of the [REDACTED] consolidated return group since [REDACTED] owns less than [REDACTED] percent of [REDACTED]'s stock.

Discussion

Issue One: Conversion of Partnership Items

The first issue in this case is whether partnership items arising from a subsidiary corporation's partnership interest will convert to nonpartnership items when the subsidiary corporation is part of a consolidated return group and the parent corporation has been notified pursuant to Temp. Treas. Reg. § 301.6231(c)-5T that it is under criminal investigation. I.R.C. § 1501 permits

an affiliated group of corporations to file a consolidated return. Generally, corporations qualify as an affiliated group if they are connected through stock ownership with a common parent corporation, the common parent owns at least 80% of the voting power and value of stock in one of the other corporations, and the common parent and other members of the group together own at least 80% of the voting power and value of stock in all other corporations in the group. I.R.C. § 1504(a).

When an affiliated group files a consolidated return, it does so essentially as a single entity. The income of each corporation in the affiliated group is calculated separately for most items. See Treas. Reg. § 1.1502-12. The separate calculations are then modified for transactions among the members of the group. See Treas. Reg. § 1.1502-13. The separate taxable income of the members and the consolidated items are then combined to arrive at a consolidated taxable income for the group from which the consolidated tax liability is computed. See Treas. Reg. § 1.1502-2.

If any member of a consolidated return group is a partner in a partnership under section 6231(a)(2)(A), all other members of the group will be considered to be "partners" pursuant to section 6231(a)(2)(B). Section 6231(a)(2) provides:

PARTNER. - The term "partner" means -
 (A) a partner in the partnership, and
 (B) any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership.
 (emphasis supplied).

Since the parent corporation of an affiliated group filing a consolidated return files a return covering all members of the group, every member of the group will have its tax liability determined in part by taking into account partnership items arising from the partnership interest of the subsidiary partner. Treas. Reg. § 1.1502-6 provides that each corporate member of a consolidated group is severally liable for the consolidated tax liability of the group. Hence, each consolidated return group member is liable for any additional tax liability resulting from the partnership items arising from the subsidiary's partnership interest. Since every member of the consolidated return group has its tax liability determined by taking into account partnership items, they are all "partners" pursuant to section 6231(a)(2)(B).

Pursuant to section 6230(c)(2) the Service has the authority to convert a partner's partnership items to nonpartnership items if it determines as provided by regulations that the conversion

of the items is necessary for the efficient and effective enforcement of the internal revenue laws. Temp. Treas. Reg. § 301.6231(c)-5T further provides:

The treatment of items as partnership items with respect to a partner under criminal investigation for violation of the internal revenue laws relating to income tax will interfere with the effective and efficient enforcement of the internal revenue laws. Accordingly, partnership items of such a partner arising in any partnership taxable year ending on or before the last day of the latest taxable year of the partner to which the criminal investigation relates shall be treated as nonpartnership items as of the date on which the partner is notified that he or she is the subject of a criminal investigation and receives written notification from the Service that his or her partnership items shall be treated as nonpartnership items. The partnership items of a partner who is notified that he or she is the subject of a criminal investigation shall not be treated as nonpartnership items under this section unless and until such partner receives written notification from the Service of such treatment.

A. Situation One

Under the facts of situation one, [REDACTED] and [REDACTED] are all affiliated corporations that are members of a consolidated return group. In each of the years at issue, [REDACTED] as the parent corporation of the consolidated return group, has filed a consolidated return that reports the aggregate income and aggregate deductions covering all members of the group. Among the items reported on the consolidated return are the distributive shares of [REDACTED] and [REDACTED] from [REDACTED]. Pursuant to Treas Reg. § 1.1502-6, each member of the consolidated return group, including [REDACTED] would be liable for any additional tax liability resulting from adjustment to these items. Furthermore, [REDACTED] as a member of the consolidated return group, would have its tax liability determined in part by taking into account the partnership items of [REDACTED]. Therefore, [REDACTED] would be a partner for TEFRA purposes in [REDACTED] pursuant to section 6231(a)(2)(B).

As previously noted, [REDACTED]'s and [REDACTED]'s distributive shares of items of [REDACTED] are reported on the consolidated return as partnership items of the entire consolidated return group. In other words, all members of a consolidated return group report the same set of partnership items. It follows that when that set of partnership items converts to nonpartnership items under section 6231(b), those items become nonpartnership items for all partners whose tax liability is determined based upon those items. Therefore, since [REDACTED] is a partner in [REDACTED] under section 6231(a)(2)(B), and is currently under criminal investigation, the partnership items that were reported on the consolidated return attributable to [REDACTED] will convert to nonpartnership items pursuant to section 6231(c)(2) and Temp. Treas. Reg. § 301.6231(c)-5T, with respect to all the members of the consolidated return group if the appropriate notice is given.

We note that Temp. Treas. Reg. § 301.6231(c)-5T provides that, ". . . [t]he partnership items of a partner who is notified that he or she is the subject of a criminal investigation shall not be treated as nonpartnership items under this section unless and until such partner receives written notification from the Service of such treatment." Therefore, we recommend that written notice should be sent to all members of the consolidated return group informing them that, because [REDACTED] is under criminal investigation, the partnership items attributable to [REDACTED] which were reported on the consolidated return of [REDACTED] are being treated as nonpartnership items. Further, we suggest that this written notification should be sent by certified mail since Treas. Reg. § 301.6231(c)-5T provides that the partnership items will be treated as nonpartnership items only upon receipt of such notice by the partner.

Situation Two

Under the facts of situation 2, [REDACTED] and [REDACTED] are both partners in [REDACTED], a TEFRA partnership. As in situation 1, [REDACTED] is part of the [REDACTED] consolidated return group. Thus, for all of the reasons discussed previously in situation 1, *supra*, the partnership items arising from [REDACTED]'s partnership interest in [REDACTED] will convert to nonpartnership items if notice is provided pursuant to Temp. Treas. Reg. § 301.6231(c)-5T with respect to all members of the [REDACTED] consolidated return group.

With respect to [REDACTED], we conclude that the notice of criminal investigation of [REDACTED] will not convert the partnership items arising from [REDACTED]'s partnership interest in [REDACTED] to [REDACTED]

nonpartnership items. While [REDACTED] is owned in part by [REDACTED], and [REDACTED] is owned by [REDACTED], and [REDACTED] is owned in part by [REDACTED], neither [REDACTED] nor [REDACTED] are part of the [REDACTED] consolidated return group. Thus, [REDACTED] would not be a partner for TEFRA purposes in [REDACTED] through [REDACTED] under section 6231(a)(2)(B) since it will not have its tax liability determined in part by taking into account the partnership items arising from [REDACTED]'s partnership interest in [REDACTED].

Furthermore, although [REDACTED] is a pass-thru partner of [REDACTED], see I.R.C. § 6231(a)(9), and thus, [REDACTED] would be an indirect partner of [REDACTED], see I.R.C. § 6231(a)(10), the fact that [REDACTED] and [REDACTED] are both shareholders of [REDACTED], will not result in them holding an interest in [REDACTED] under Temp. Treas. Reg. § 301.6231(a)(2)-1T(b). (A shareholder of a C corporation . . . is not a partner in a partnership merely because the C corporation is a partner in the partnership). Therefore, since the tax liability of [REDACTED] is not determined either directly or indirectly by taking into account the partnership items arising from [REDACTED]'s partnership interest in [REDACTED], giving notice to [REDACTED] that it is under criminal investigation will not convert those partnership items to nonpartnership items under Temp. Treas. Reg. § 301.6231(c)-5T.

Issue Two

Since we have concluded in issue one that all of the partnership items reported by the [REDACTED] consolidated return group attributable to [REDACTED] and [REDACTED] will convert to nonpartnership items upon receipt of the notice under Temp. Treas. Reg. § 301.6231(c)-5T, the issue then arises as to whether the period of limitations on assessment can be kept open for all the members of the consolidated return group, if it is determined that there is fraud at the partnership level (i.e. [REDACTED] or [REDACTED]). There are several statutory provisions which must be considered in making this determination.

As a general rule, section 6229(a) provides that the period for assessing any tax imposed by subtitle A attributable to partnership or affected items shall not expire before 3 years after the later of the date the partnership return was filed or the last day for filing such return (determined without regard to extensions).

If there is fraud at the partner level, section 6229(c) provides an extended period of limitations for making assessments. Section 6229(c) provides in part:

(c) Special Rule in Case of Fraud, Etc. -

(1) False Return. - If any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item -

(A) in the case of partners so signing or participating in the preparation of the return, any tax imposed by Subtitle A which is attributable to any partnership item (or affected item) for the partnership taxable year to which the return relates may be assessed at anytime, and

(B) in the case of all other partners, subsection (a) shall be applied with respect to such return by substituting "6 years" for "3 years".

Section 6229(f) provides that the period for assessing any tax imposed by Subtitle A attributable to converted items under section 6231(b) shall not expire before the date which is one year after the date on which the items become nonpartnership items.

Finally, with respect to nonpartnership items in general, section 6501(c)(1) provides that, "[i]n the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed or a proceeding in court for collection of such tax may be begun without assessment, at any time."

This office has taken the position that section 6229(f) and section 6501 create separate periods of limitations and that the period of limitation under section 6229 will normally govern in the case of partnership items and converted items. In the present case, since we have concluded that the partnership items will convert to nonpartnership items with respect to all the members of the [REDACTED] consolidated return group if the appropriate notice is given, section 6229(f) is the specific provision regarding the statute of limitations that applies to those items. The converted partnership items could arguably, however, also be governed by section 6501(c)(1), where the requirements of that section are met. See Litigation Guideline Memorandum TL-81. Under this interpretation, the period of limitations would be kept open indefinitely for members of the consolidated return group only with respect to the tax attributable to the converted partnership items. ^{1/} However, the interpretation

^{1/} Even if only one member of the consolidated return group may have participated in the fraud, the period of limitations on assessment for the entire group will be kept open since Treas. Reg. § 1.1502-6 provides that each member of the consolidated return group is severally liable for any tax liability of the group. See J. Crestol, K. Hennessey, A. Rua, The Consolidated Tax Return 9-23 (1988).

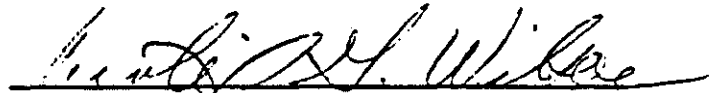
that section 6501(c)(1) may apply when there is fraud in connection with the partnership return and a partners' items have converted presents substantial hazards of litigation for the Service. Therefore, it is our position that if notice of conversion of partnership items is given to the [REDACTED] consolidated return group, and it is determined that there is fraud in connection with either the [REDACTED] or [REDACTED] partnership returns, the Service is limited to the one year period of limitations provided by section 6229(f).

We point out that when partnership items have converted to nonpartnership items because of criminal investigation, the one year period of limitations under section 6229(f) will not begin to run until written notice is received by the partner, stating that the partner is under criminal investigation and that his partnership items are being treated as nonpartnership items. See Temp. Treas. Reg. § 301.6231(c)-5T. Therefore, to the extent that it is determined that the criminal investigation of [REDACTED] will not interfere with the TEFRA partnership audit of [REDACTED] or [REDACTED] we recommend that the notice of conversion of partnership items not be given, so that the Service may retain the benefit of the longer section 6229(c) period of limitations, if the requirements of that section are met. However, if it is determined that the criminal investigation of [REDACTED] will interfere with the TEFRA partnership audit of either [REDACTED] or [REDACTED], we recommend that the factual development of the fraud case against the partnerships be developed as fully as possible, to the extent permitted by the criminal investigation of [REDACTED], prior to the issuance of the notice of conversion, so that the Service may assert fraud in the notice of deficiency, which would have to be issued within the one year period of conversion under section 6229(f).

Should you have any further questions regarding this matter, please contact Jeff Rosenberg at (FTS) 566-3233.

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